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Keating Case A Surprise Test Of U.S. Powers

By ROBERT TRIGAUZ

WASHINGTON — A few months ago, virtually no one gave Charles H. Keating Jr. a chance of winning a suit seeking the return of his seized thrift, Lincoln Saving and Loan Association. But now that Mr. Keating is having his day in court, some observers are beginning to hedge their bets.

Mr. Keating was to conclude his testimony today in hearings that legal experts say are proving to be a surprising test of federal regulators' power.

"Typically, cases like this never get this far," said one thrift lawyer, who noted that courts tend to defer to federal agencies in matters of bank and thrift supervision.

Lincoln was taken over by the government almost a year ago, and thrift regulators have said it will cost the government \$2 billion or more to cover its losses. In litigation that has cast the controversial Mr. Keating into the national spotlight, Lincoln and its parent, American Continental Corp., have sued the government to reverse the takeover.

To be sure, most lawyers still expect the government to prevail and retain control of Lincoln Savings. But, said one lawyer, "I am less certain today than two months ago."

Mr. Keating's spirited attack on the government has far exceeded the expectations of the legal community. In testimony last week, for example, his questions about how regulators wrote down Lincoln assets seemed to put the government on the defensive. Federal District Judge Stanley Sporkin asked the defense to supply information on how Lincoln's assets were valued.

Conservatorship Deemed Key

"If I were FDIC general counsel, I'd be worried," said one former government attorney who asked not to be identified. "There's so much going on with respect to Keating. Maybe the regulators will be in fine shape, but if the activities of Lincoln's conservatorship are called into question — wow!"

Indeed, some attorneys point to the recent success of Olympic Federal Savings and Loan, Berwyn, Ill., in at least temporarily halting the Office of Thrift Supervision from seizing it. That decision was later overturned, but thrift lawyers say it shows that federal agencies are not all-powerful in the court system.

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CITICORP ANNOUNCED that it has switched \$30 million in telecommunications business from AT&T to MCI Communications Corp. *Page 3*

CONSUMER

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THE SYNDICATION of a \$680 million loan to finance Georgia Gulf's leveraged recapitalization appears to be going well. *Page 22*

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IRVING MARGOL, head of Security Pacific's community reinvestment initiative, has spent years aiding the cause of minorities at the bank. *Page 2*

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AN OVERSUPPLY of small shopping centers may pose a host of new problems for banks. *Page 8*

OTHER NEWS

BANC ONE CORP. posted first-quarter profits of \$101.8 million, up 16.7%. Its Texas unit contributed \$10.7 million. *Page 2*

COMMENT

BANKERS FAMILIAR with methods of comparing investment opportunities have a better chance of making optimal choices, writes Sanford Rose. *Page 4*

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Deposits Rose Less than 5% At Credit Unions Last Year

By BILL ATKINSON

WASHINGTON — In the legislative battle to rein in credit unions, bankers have lost some of their fuel. They can no longer complain of skyrocketing deposit growth at their tax-exempt rivals.

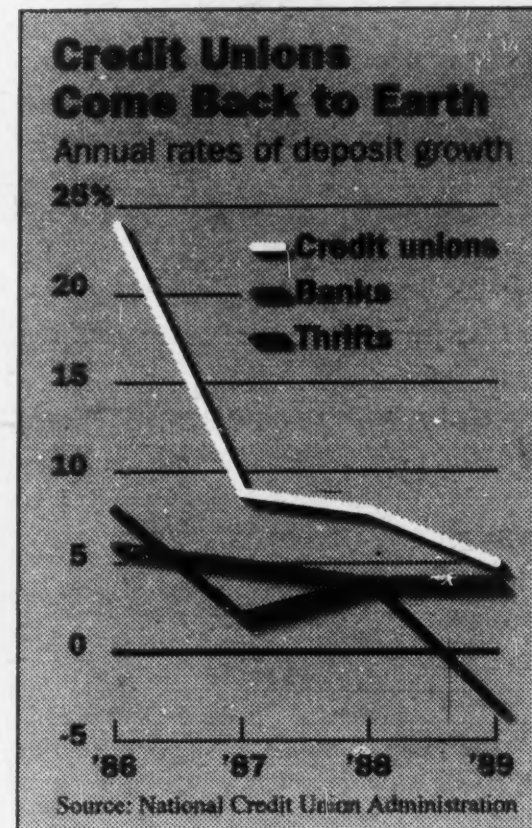
Data from the National Credit Union Administration show that deposits rose 4.7% in 1989 at the federally insured institutions it regulates. That is the lowest percentage gain in eight years and is in stark contrast to increases exceeding 20% in 1985 and 1986.

Growth in Line with Banks'

The growth at credit unions was slightly ahead of the 4% deposit increase at commercial banks last year, but commercial banks' aggregate \$2.5 trillion in deposits dwarfed the \$167 billion in credit unions.

Meanwhile, bankers are blasting credit unions, charging them with unfair competition. In a national lobbying effort, the American Bankers Association has accused credit unions of stretching the definition of common bonds — the membership definition that historically limited their customer bases — and has called for an end to their tax-exempt status.

Industry followers contend that the credit union slowdown



is a result of several economic and competitive factors — and perhaps some jawboning by the National Credit Union Administration to deflect criticism from bankers. While the regulatory agency has emphasized capital ahead of growth, credit union interest rates have fallen more in line with those of financial institutions, and competition is intense for a limited pool of consumer savings.

"I don't think we will see growth like [the mid-1980s] for years," said John T. Roycroft, vice president of Callahan and

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Chase Profit Drops 67%; Real Estate Is Pothole

By JED HOROWITZ

NEW YORK — A higher-than-expected increase in bad real estate loans battered Chase Manhattan Corp.'s profits in the first quarter, while Manufacturers Hanover Corp. and J.P. Morgan & Co. reported a decline in core earnings more in line with investors' expectations.

Stocks of the three bank companies were down at the close on Monday, while major market indexes edged up. Chase slipped \$1.50, to \$27.875; Morgan eased 12.5 cents, to \$35.375; and Manufacturers Hanover fell 25 cents, to \$34.25.

Chase said its net income in the quarter fell 67% to \$44 million, largely because of a 73% increase in its loan-loss provision and a \$272 million increase in nonperforming real estate loans. Several analysts said they might reduce their yearly estimates for the nation's second-largest bank company because of the extensive real estate problems.

Manufacturers Hanover said its net income fell 7% to \$96 million, but analysts applauded the

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Bank of NY Deal Becomes Dispute Over Stock Value

By GORDON MATTHEWS

NEW YORK — The proposed friendly acquisition of Northeast Bancorp. by Bank of New York Co. turned nasty Monday as a \$377 million dispute over the value of the deal became public.

The dispute came to the forefront as Bank of New York prepared to file an application with the Federal Reserve Board for the purchase of the Stamford, Conn., bank.

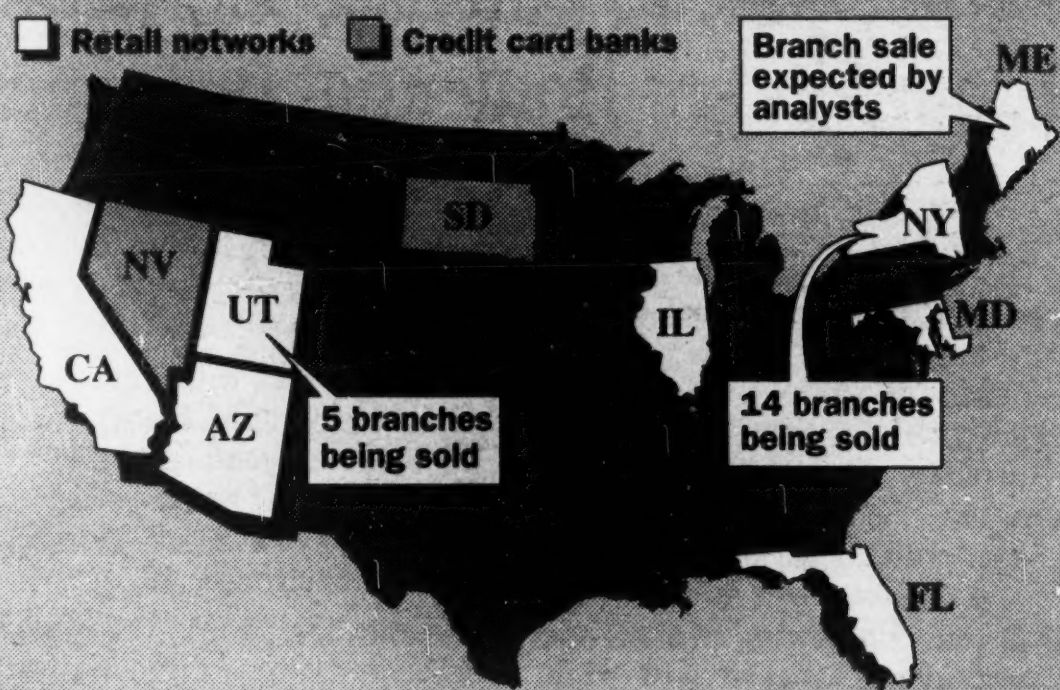
At issue is a wide disagreement over the book value of Northeast's shares, in light of the deterioration of Connecticut real estate values.

In a statement late Monday, reported by Reuters, Northeast management said it could not understand how Bank of New York determined a book value of \$12.31 for each Northeast share as of Dec. 31. Northeast put its yearend book value at \$33 a share.

Bank of New York had agreed to a purchase price of 2.5 times

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Citicorp Refines Its Consumer Network



Citicorp Is Beginning to Define Limits of Its Domestic Expansion

By ELLEN MEMMELAAR

NEW YORK — Citicorp, the company that many smaller banks have come to fear the most for its ability to enter new markets seemingly at will, is becoming selective about where it will go.

In recent weeks, Citicorp has agreed to sell branches in upstate New York and Utah to banks more active in those areas. Analysts expect more branch sales as Citicorp tries both to bolster its

capital and focus on regions and businesses that it deems integral to its strategic plan.

The moves do not signal a full-scale retreat from retail markets by the nation's largest banking company. Citicorp boasted in its recent annual report that it provides at least one service to one in four American households. Much of that reach comes from the company's vast credit card operation, which has issued

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COMMENT / By Sanford Rose

How to Calculate Investment Returns

How should a banker determine where to invest his institution's funds? Although many bankers are familiar with the methodology for comparing investment opportunities, a significant number are not. And this lack of familiarity often results in suboptimal financial choices.

Quite obviously, it makes little sense to choose among competing assets by looking only at their gross yields. These yields must be adjusted for the cost of match-funding the investments plus likely credit losses, non-interest expenses, and options risk - e.g., the risk that a borrower will prepay his loan.

Additionally, to figure out his bottom-line profit, the banker must divide his returns by an amount of allocated capital sufficient to cover unexpected losses. Since the amount of unexpected losses depends crucially on the extent of portfolio diversification, the banker cannot view each investment opportunity in isolation.

He must assess how the marginal investment meshes with his existing portfolio. For example, will a new loan improve portfolio diversification because the fortunes of the new customer tend to vary inversely with those of existing customers? Or will it increase concentration risk because a given economic shock is likely to have much the same impact on the new customer as on the old ones?

Diversification analysis is complicated. So for the sake of simplicity, let us assume that each of three investment opportunities - a conventional whole mortgage loan, a consumer loan, and a junk bond - have the same diversification impact on the banking company's portfolio.

Given this assumption, Michael Giarla, a partner at Smith Breden Associates, an investment counseling firm based in North Carolina, offers the following analysis of the returns promised by each of these investment choices.

Costing the Rate Risk

The gross yields on the three assets are assumed to be as follows: the mortgage, 11%; the consumer loan, 12%; and the junk bond, 14.5%. The bank's short-term funding cost equals 8%. But since each asset has a different average life, the banker must fund at a different maturity in order to neutralize interest rate risk. The extra costs of match-funding the assets - that is, the premiums over the short-term rate which must be paid to get longer-dated funds - are assumed to be 1% for the mortgage (although, in actual practice, this figure is probably considerably understated), 0.50% for the consumer loan, and 0.75% for the junk bond.

Next the banker must adjust the yields for average credit losses - say, 0.50% for the mortgage, 1.50% for the consumer loan, and 4% for the junk bond. Options, or prepayment, risk necessitates the following further subtractions: 0.60% for the mortgage, 0.40% for the junk bond, and only 0.10% for the consumer loan.

Tallying these deductions, the banker notes that the consumer loan appears to afford the highest margin - 1.80% versus 1.35% for the junk bond, which is clobbered by the high credit-risk deduction, and only 0.90% for the mortgage, which has the lowest gross yield and also the most options risk.



Capital earns its share of the assets - plus the leverage spread.

But, of course, the banker can't stop here. He has to make a final deduction for noninterest expenses. These are assumed to vary from 0.25% for the mortgage, to 0.50% for the junk bond, to 1.50% for the consumer loan.

Hence, we arrive at a net "expected" spread of 0.30% for the consumer loan, 0.65% for the mortgage, and 0.85% for the junk bond. The emphasis is on the word "expected" because the banker could have been incorrect in many of his assumptions. For example, as noted, the mortgage may, and very probably does, have a much higher match-funding cost than is being estimated here.

Calculating the Bottom Line

Nevertheless, having made his best guesses, the banker is now prepared to divide the expected net spreads by the amount of allocated capital. According to regulatory requirements, the banking institution needs only 4% capital to backstop the mortgage, but 8% for both the consumer loan and the junk bond.

If, after analyzing the likely variance of losses on each asset, the banker is satisfied that he needs no more than the minimum capital required by the reg-

ulators in each asset category, he can proceed to determine his bottom-line profit or return on allocated capital.

This calculation, however, is a bit trickier than most people think. The banker's capital earns its share of the assets plus the leverage spread - i.e., the spread between the remaining assets and liabilities.

So for every \$100 invested in mortgages, the rate earned on the \$4 in required capital equals 8.65% - the full 11% gross yield minus the allowances for credit, interest rate, and options risk and for noninterest expenses. And the rate earned on the remaining \$96 of invested assets equals 0.65% - the gross yield minus all the various adjustments and the 8% short-term funding cost.

Lowest Yield, Highest Profit

This produces a pretax return of 24.3% on the mortgage. And the same calculation shows an 11.9% return on the consumer loan and an 18.6% return on the junk bond.

So, despite the fact that the mortgage has the lowest gross yield, it results in the highest bottom-line profit. A decision based on yield alone would have produced an incorrect choice (the junk bond), as would a decision based solely on risk-adjusted margin (the consumer loan).

To be sure, if the difference between long and short rates is such that the cost of adjusting the mortgage for interest rate risk is not 1% but closer to 1.8%, the picture changes radically. The net mortgage spread equals minus 0.15% and the return on equity is a minuscule 4.3%.

The point is that the banker must make sure that his assumptions are unbiased and reasonably accurate. Only then can he hope to arrive at the optimal choice of assets, provided he incorporates all the elements required for the analysis - yield; cost of funds; adjustments for interest rate, credit, and options risk; noninterest expenses; and capital allocation. □

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CRIME BLOTTER / By Tom Leander

Three Convicted In Montana Fraud

Real Bird, the tribal chairman of the Crow Indians of Montana, was convicted last week of two counts of bank fraud and one count of conspiracy in connection with a loan scam involving officials from the Crow reservation near Billings.

Also convicted in U.S. District Court were Willie Stewart Jr., who is chairman of the Crow Land Resources Committee, and Theodore Hogan, former tribal secretary.

The defendants were accused of misleading First Citizens Bank of Billings and the Billings Credit Union into approving loans by assuring loan officers that the tribe was in the process of buying \$296,500 of Mr. Hogan's land, even though they knew the land had already been foreclosed on by Little Horn State Bank, Hardin, Mont.

U.S. Attorney Carl Rostad said the defendants had pocketed more than \$50,000 as a result of the scheme. The convictions

are expected to be appealed.

Sentencing was scheduled for July 17. The three each face up to 12 years in prison.

Oregon Robberies Down 46% in 1989

Oregon banks, which experienced the highest rate of bank robberies in the nation in 1988, got a breather last year. The number of bank robbers fell 46% to 187, down from 346 in 1988, according to the Federal Bureau of Investigation.

The FBI in Portland attributed the drop to a crackdown on crime.

Decision Is Made In Polygraph Case

A bank executive and the bank's in-house counsel at Minnesota Savings Bank, Minneapolis, will not have to pay punitive damages for ordering an employee to take a polygraph test. The court determined they did not know of a state ban.

The law bans the solicitation of a polygraph test by an employer and creates a private cause of action if a boss imposes such a test. But the court found that the punitive damages can be awarded only if the officers had shown a "willful indifference" to the Minnesota law and also found that the bank executive and attorney showed "good faith but mistaken belief."

The court, however, upheld punitive damages against the bank security officer, who had knowledge of the law but administered the tests anyway.

Two Men Accused As Taxi-Using Robbers

Two Chicago men who allegedly robbed banks using a waiting taxi as a getaway car were arrested in Chicago recently, after FBI agents traced the men to a motel by using cab company records.

Charles Tinsley, 33, and Andrew Traeger, 37, are suspects in the robberies of Heritage Bank of Oak Lawn on March 24; LaSalle National Bank, Chicago, on March 19; and North Community Bank, Chicago, on March 16.

In each robbery, witnesses told police, one robber would remain in the cab while another entered the bank and handed the tellers a threatening note. No weapons were used.

FBI spokesman Robert Long said that Mr. Tinsley and Mr. Traeger are suspected of mailing back half the \$6,600 allegedly stolen from Heritage Bank. Investigators were trying to learn the motive for the payoff.

License Number Aids In Suspect's Capture

Michael Krijteman was clad in a towel and on his way to the shower to wash off the red dye from an exploding packet of loot when, police said, they rang his doorbell and nabbed him for robbing Rockland Trust Co. in Brockland, Mass., an hour before.

Mr. Krijteman, 30, a suspect in seven other bank robberies in the area, allegedly entered the Rockland branch and handed over a note to the teller that read "Give me money. I have a gun." The teller handed over an undisclosed sum of money that hid a packet of exploding red dye.

A witness copied down the license plate number. □

STOCKS

Dispute Brews Over Book Value Of Northeast

Continued from page 1

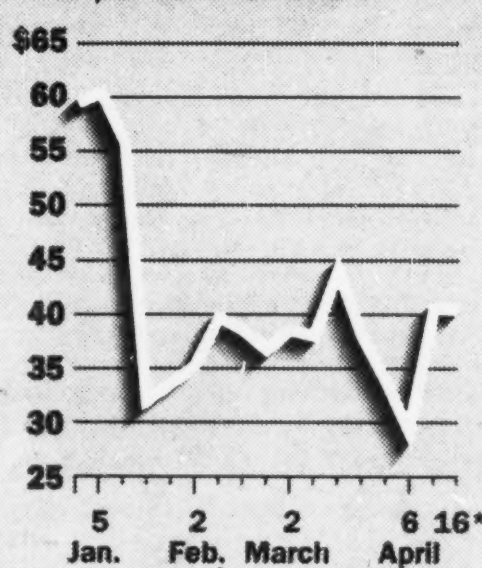
Northeast's book value. In effect, Northeast calculates the value at about \$602 million, while Bank of New York puts it at about \$225 million.

Shares of Northeast Bank never opened for trading on Monday.

The stock skyrocketed \$11.25 to \$40.50 in two days last week after Bank of New York chairman J. Carter Bacot said a filing was imminent. The stock traded as high as \$61 in January, before Mr. Bacot made pessimistic remarks about the merger.

Northeast Bancorp's Rugged Ride

Price per common share



*Price of \$40.50 as of 3:30 pm
Source: DB Technology Inc.

Separately, Northeast reported a loss of \$6.5 million for the first quarter, versus a profit of \$8.7 million a year ago.

The bank added \$27.5 million to its reserve for loan losses and charged off \$28.5 million of bad loans in the quarter. Reserves fell to \$49.6 million at the end of the quarter from \$50.1 million at yearend.

Setting the stage for a potential legal donnybrook, Northeast said it was prepared to enforce its merger pact with Bank of New York, according to the terms of its agreement as well as on the basis of the book value approved by its auditors.

This dispute marks the latest chapter in the saga of what is often regarded as one of the nation's landmark, if incomplete, bank acquisitions. The deal has been pending since 1983.

Landmark Deal

Bank of New York's plan to acquire Northeast prompted the U.S. Supreme Court to decide in 1985 that states did not violate the Constitution by forming exclusive regional compacts to prevent entry by banks from large states like New York.

The high court ruling ushered in the era of interstate banking, but put the Bank of New York-Northeast deal on hold. In the meantime, the stakeout arrangement has supported the stock of Northeast, which is based in Stamford, Conn., and is the parent of Union Trust Co.

With a recession in New England, the Connecticut legislature this year dispensed with the

New England compact and opened the state to all entrants on a reciprocal basis. That finally placed the Bank of New York deal in the realm of possibility.

But that was after Northeast had reported weakened fourth-quarter earnings that caused its stock to plunge. Investors grew worried that Bank of New York would balk at completing the deal because of the collapse of New England's real estate market and sharply higher nonperforming loans at Northeast.

Observers believe this is the last point at which Bank of New York could file the application and expect to get a regulatory decision in time to meet the Aug. 15 expiration date on the merger agreement.

Yesterday's Market

Last week's bank stock rally did not survive the long Easter holiday. The stock market was broadly higher on Monday, but big bank stocks mostly edged lower as cautious investors attempted to digest a flood of bank earnings announcements.

Several analysts said the market for bank stocks seemed to be hurt by reactions to a trio of earnings announcements from New York money-centers, and by a wait-and-see attitude about the earnings and dividend of Citicorp, which is expected to report results today.

In late afternoon trading, Chase Manhattan Corp. slipped 37 cents to \$29, J.P. Morgan & Co. eased 12 cents to \$35.37, and Manufacturers Hanover Corp. fell 25 cents to \$34.25. At the same time, Citicorp eroded 12 cents to \$24.75.

"The Chase earnings report was very disappointing, and Morgan was not exciting," noted Richard X. Bove, an analyst for Dean Witter Reynolds Inc. "Manufacturers did better than expected, but the stock was down anyway."

CAPITAL

LDC Reserve Picture Rosier, Study Shows

By KELLEY HOLLAND

There's a bright spot on the horizon for banks' loan-loss reserves, according to a report released by Keefe, Bruyette & Woods Inc.

Because much of the Mexican debt exposure of American banks has been restructured into more secure bonds collateralized by Treasury securities, many of the banks could begin to show a better reserve ratio against their loans to lesser-developed countries.

That's good news for banks that have been struggling to boost loan-loss reserves. The Keefe study indicates that major banks' reserves against medium- and long-term loans to Third World countries could increase to about 65%, up from 51%.

"An important element of the LDC picture has been dealt with through the Mexican debt restructuring," said James J. McDermott, director of research at Keefe Bruyette. "It should promote a decrease in LDC fears."

Banks were offered three options in the debt restructuring agreement with Mexico. They could exchange their loans for new bonds collateralized by Treasury bonds with a lower principal amount but the same coupon as the rate on the loans. They could exchange their loans for bonds with the same principal amount but a lower interest rate, or they could lend new money to Mexico equal to 25% of their loans.

Several Options Exercised

Banks could choose any of the options for part or all of their term loan portfolio. Their selections ran the gamut, with Citicorp only lending new money against its portfolio and Bank of

A Scorecard on Mexican Debt Plan

	Principal reduction bond	Interest reduction bond	New money
Bank of New York Co.	100%	0%	0%
BankAmerica Corp.	0	60	40
Bankers Trust New York Corp.	25	75	0
Chase Manhattan Corp.	30	70	0
Chemical Banking Corp.	30	70	0
Citicorp	0	0	100
Continental Bank Corp.	0	100	0
First Chicago Corp.	0	100	0
Manufacturers Hanover Corp.	50	50	0
J.P. Morgan & Co.	50	50	0

Source: Keefe, Bruyette, & Woods Inc.

New York planning to exchange all its loans for the principal-reduction bonds.

Calculating LDC loan exposure as if they had written down their principal-reduction bonds and excluded their Mexican loans from their LDC loan exposure as of the end of 1989, money-center banks' reserves rose to 65% of their LDC loan exposure from 51%, at the end of 1989.

First-quarter earnings announcements now coming out will give industry observers their first peek at how banks intend to account for their newly restructured Mexican loans. The Mexican debt swap idea was advanced in the fall of last year, and banks signed off on the plan during the first quarter.

Key Accounting Issues

Key questions are whether the banks will write down the loans they exchanged for principal or interest-reduction bonds, and

whether they will classify any or all of their restructured loans as nonperforming assets.

Banks' accounting treatment of their new Mexican bonds varies widely, and makes it harder for investors to compare different banks' performance.

"There's enormous head-scratching going on," said one analyst.

Take J.P. Morgan, for example. That bank took a first-quarter charge of \$232 million because the bank wrote down both its interest-reduction bonds and its principal-reduction bonds. In contrast, Manufacturers Hanover Corp. reported a 35% write-down only on the \$639 million it restructured as principal-reduction bonds. The banks' principal-reduction bonds were issued at 65% of the face value of the loans exchanged.

Banks vary as well on whether they will classify their restructured Mexican loans as nonperforming assets.

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Why,
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